United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

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IN THE

United States Court of Appeals

For the Second Circuit

HUNTINGTON TOWERS, LTD.
and RICHARD CAREY,
Plaintiffs-Appellants,
against

FRANKLIN NATIONAL BANK (in liquidation) and
FEDERAL DEPOSIT INSURANCE CORPORATION,
Defendants,

FEDERAL RESERVE BANK OF NEW YORK,
EUROPEAN-AMERICAN BANK, and JAMES SMITH,
individually and as Comptroller of the Currency,
Defendants-Appellees.

On Appeal from an Order of the United States District Court for the Eastern District of New York

REPLY BRIEF FOR PLAINTIFFS-APPELLANTS

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REPLY BRIEF FOR PLAINTIFFS-APPELLANTS

Preliminary Statement

Appellants' reply brief will consider each of the appellees' briefs. Not all points raised by the appellees will be discussed in this brief because some of the arguments have already been considered in the main brief and other arguments are not sufficiently substantive or meritorious to warrant further discussion.

The Federal Reserve Bank (FRB)

I. The FRB lacks authority to lend to an insolvent national bank.

The FRB bases its main defense to the claim of the appellants upon the ground that FRB had statutory authority to make advances to national banks facing a liquidity crisis. FRB further relies upon the declaration made by the Deputy Comptroller that FNB was solvent in May, 1974. FRB argues that if the appellants' claim against FRB is sustained, then the entire national banking system would be thrown into chaos because of the uncertainty and the substantial risk that exists for any bank, and particularly federal reserve banks in lending money to a bank that is facing a liquidity crisis. Such an argument is patently false.

As stated in the appellants' main brief, the FRB is duty bound to make its own determination as to solvency and insolvency when it makes advances to member banks. Furthermore, it is not permitted to make advances to insolvent banks. FRB places its main reliance upon the fact that the Deputy Comptroller determined the question of solvency and that, therefore, FRB was entitled to rely upon that determination, and if that reliance were wrong or the determination by the Deputy Comptroller were wrong, then FRB was free from liability because of the Comptroller's defense of sovereign immunity. In part, FRB relies upon cases cited at page 24 of FRB's brief which do not support FRB's contention. Furthermore, these cases do not support FRB's contention that decisions in the matter of lending money to insolvent banks are entirely within FRB's discre-

tion and that that discretion may not be attacked in the courts. The cases cited involve factually different situations such as fixing rates by the Federal Open Market Committee; a widow seeking two pensions from the Navy; the Secretary of the Treasury's fixing of duties on sugar; and the right of the Postmaster General to advise local postmasters not to honor an attorney's fee for the collection of a claim that was granted by the Congress.

The FRB cleverly denies that it is seeking to place itself in a position of attaining sovereign immunity on its decisions on loans to its member banks. However, the thrust of the argument and the cases (all involving federal officials) clearly demonstrate that it wishes this Court to sustain the lower court's decision on this very issue. It should be observed that the argument that the regulators will be unable to properly regulate if their actions are subject to judicial review in private litigation is a patently erroneous argument. There is no reason why the courts of this land cannot consider fairly and efficiently whether or not the regulators have, in fact, violated the rules and laws that have been enacted to regulate the regulators and the National Bank system. When the banking system fails to lawfully operate and function causing damage to a citizen, is there to be no recourse to the courts as urged by the FRB? This Court should reject such a contention.

The argument advanced by the FRB is one similar to the national security argument that permitted goverment officials to authorize massive arrests of demonstrators in Washington and the violation of the constitutional rights of citizens throughout the land. The argument being raised by the FRB and the Comptroller is a similar argument, only

this time, they seek to protect the security of the national banking system. If the national banking system becomes an instrument to impoverish or destroy certain classes of plaintiffs (such as the appellants) or take property by one fashion or another from people who do business within the banking system, then there must be a judicial outlet valve that will permit aggrieved persons to bring their claims to a tribunal where they can be heard and fairly and justly determined. There is no tribunal authorized or existing under the present banking system in this country absent resort to the federal courts. It is also argued by FRB that there is no duty owed by the FRB to customers of member banks to, at a minimum, warn them or in some positive way to react when it becomes privy to the fact that a member bank is insolvent. This contention, if found to be valid, seems to support the proposition that not only is there no duty to warn customers of an insolvent member bank, but additionally, the FRB is free to treat that bank in any fashion that it wishes, including extending to it such credit as to give it the appearance of solvency for a long period of time in order to permit other member banks to withdraw funds which may not be insured by the FDIC. There is no authority for the FRB to lend money to an insolvent bank. In fact, only the FDIC has been given that authority by Congress.

It would seem, from reading the brief of the FRB, that there is a complete lack of understanding on the part of the FRB of its duties and responsibilities in a situation where a member bank becomes insolvent. FRB's arguments seem to characterize and describe the present banking system in our country as one that casts no duty or liability upon the Comptroller, the FDIC, or the FRB. Modern concepts of

social justice and responsibility of non-governmental and governmental bodies compel a different answer. Sovereign immunity defenses for the Comptroller and FDIC in the regulation of the banking industry should be abrogated.

II. The authority of the Comptroller is subject to judicial review.

The FRB is compelled to argue the Comptroller's case as part of its case. At page 29 of the FRB brief, a number of cases are cited that allegedly support the proposition that the Comptroller had the authority and power to act as he did with FNB. An analysis of the cases cited by FRB shows that the bulk of the cases consist of actions by or against stockholders of national banks who are arguing about their obligation or liability for assessments to be levied by the receiver of an insolvent bank (as was once permitted under the National Bank Act). Some cases challenge the power of the Comptroller to close admittedly insolvent banks. One case involves the conviction of a national bank officer for violation of state law. However, none of these cases stands for the proposition that the Comptroller has the power to act in the manner that he did in the case of FNB.

The court should also take particular note of the fact that many of the cases cited in the briefs of the appellees concerning the banking system spring out of a unique period in American history; that is, they are from the era of the depression and the era of massive federal intervention and regulation of banking and other industries. In prospective, these cases spring from a desperate period of American economic history. There are few, if any, modern major upper court decisions involving the powers of the

Comptroller and the regulators and their responsibility and accountability for excesses and abuses in the conduct of their operations. This Court is invited to give fresh guidance to them.

III. The FRB lien is null and void as being a preference among creditors.

The FRB has argued that it was entitled to receive collateral for advances to FNB. It is, perhaps, a fair statement that a reserve bank may make advances to a member bank that may be facing a liquidity crisis where it is clearly evident that the bank is not insolvent. However, if it is known that the bank is insolvent or if a reasonable banker, upon reasonable inquiry, would have been on notice that there was a peculiar or unusual banking practice which would occasion the need for further investigation and that banker failed to inquire and the net effect of the receipt of collateral for advances was to create a preference to the detriment of creditors, there is no doubt that such a preference should be set aside as being improper and unlawful. In fact, none of the cases cited by the FRB stands for the proposition that the FRB, or for that matter any bank, can make a loan or create a preference with an insolvent bank. The cases cited at page 35 of the FRB's brief concern the enforcement of purchase and assumption agreements between banks, one bank having taken over the other. In those cases the courts enforced the terms of the purchase and assumption agreement among the banks and their stockholders and officers.

As previously stated in the appellants' main brief, a preference in contemplation of insolvency is one that can

be created where the officers of the insolvent bank have reason to know of that insolvency. There is ample evidence in this case that the officers of FNB and for that matter, the officers of the FRB and the Comptroller knew th[illegible] FNB was insolvent. This Court need go no further than state that if such a finding is made in this case, then the appellants will have established a cause of action to (a)void the lien claimed by FRB. The FRB is in no position to argue that it has a right to enter into agreements with the FDIC for disposing of FNB's assets and creating and preserving liens in FRB's favor to the detriment of all other creditors of FNB.

None of the cases cited by FRB authorizes loans by federal reserve banks to an insolvent bank, and indeed, this is not permitted under the law. *Hiring* v. *Federal Reserve Bank of Minneapolis*, 52 F.2d 382 (8th Cir. 1931); *Vann* v. *Federal Reserve Bank of Richmond*, 47 F.2d 786 (E.D. Va., 1929); *Federal Reserve Bank of Kansas City* v. *Omaha National Bank*, 45 F.2d 511 (8th Cir. 1930).

IV. The appellants suffered legal injury.

FRB believes that no legally compensable injury was sustained by Huntington Towers. As previously indicated, Huntington Towers has lost by foreclosure building I which was approximately 60% rented at the time of the foreclosure. Building II presently stands partially constructed on several acres of valuable land and is approximately 20% completed. Presumably, this property will be foreclosed by subcontractors or the FDIC acting either in its corporate capacity or as trustee for FNB. But for the financial collapse and insolvency of FNB, and the failure

of the appellees to properly act, Huntington Towers II would be constructed and rented by this time. If the appellants were advised in May or June of 1974 that FNB would no longer be able to fund the construction of this building, then the appellants would have been able to immediately stop construction of building II and mitigate damages. Alternatively, appellants could have refused to give additional security to FNB because of FNB's inability to deliver the funding as consideration for the additional security. Also, the total indebtedness of the appellants to FNB would have been substantially reduced. The appellants would have had an opportunity to seek alternative financing elsewhere so that the building could have been completed. Lastly, once the appellants became so financially locked into FNB as they did in June, 1974, it became virtually impossible for them to obtain financing from other sources.

FRB relies heavily upon a New York Court of Appeals case: *Dwelle-Kaiser Co.* v. *Aetna Casualty & Surety Co.*, 241 N.Y. 464, 150 N.E. 517 (1926), for the proposition that no cause of action exists in favor of the plaintiffs. Certainly a construction contract case has limited, if any, applicability to a banking situation where the underlying purpose of the agreement between the bank and the customer is to provide financing. Certainly, a bank cannot be permitted to accept security and then not deliver the consideration (*i.e.*, the money) to the customer. In *Dwelle,* the court stated that the subcontractor could have demanded cash payment upon learning of the insolvency of the general contractor. Appellants herein could have demanded cash and other consideration for the security interest that was given in June, 1974, to FNB.

Appellant Carey was a customer of FNB for a number of years. Carey was so deeply involved in this construction project and other financial arrangements with FNB, it was perfectly logical for him to rely upon the continuing relationship that had been in existence for a number of years. The relationship at the bank had to be very close for the bank to be funding a building of this size during 1974. The speculation that the appellants had to provide this security belies the fact that appellants could have taken the financing of this building elsewhere, but as a consequence of tying themselves completely to FNB, their ability to move within the financial community and obtain alternative financing was, in effect, destroyed. The greatest damage was done in June, 1974. All of that damage could have been avoided by timely and prompt action on the part of the regulators. Regulators should individually be made to stand and answer for their outrageous conduct in this matter.

The Comptroller

I. The Comptroller acted outside the scope of his authority.

At page 2 of the Comptroller's brief, it is stated that the Comptroller acted within the scope of his official duties at all times as sworn to by the Secretary of the Treasury. If true, then presumably the Secretary of the Treasury might well be liable to the extent that the Secretary participated in and approved the Comptroller's unlawful conduct in creating a preference in violation of federal law. Also, it is stated that the appellants have never alleged that the Comptroller acted outside the scope of his authority. At paragraph 6 (JA4) and paragraph 24 (JA9) of the com-

plaint the appellants clearly allege illegal conduct on the part of the appellees, including the Comptroller. Presumably, the Comptroller is acting outside the scope of his authority if he is performing acts which are in violation of federal law.

II. The court has power to grant relief against the Comptroller.

If the appellants are not entitled to monetary relief against the Comptroller, the appellants are still entitled to declaratory or injunctive relief as appropriate to compel the Comptroller to act within the scope of his authority so as to protect those who have been damaged by his unlawful conduct and that of the receiver FDIC and FRB. It is clear that this Court has the authority to compel the Comptroller to undo an unlawful act and to rectify the damage to the appellants. It also seems to be true that the *ex parte* hearing by the lower court determining the rights of creditors is violative of due process and does not afford other creditors the opportunity to be heard. If the lower court is correct in granting sovereign immunity status to the FDIC and FRB and they received the assets of FNB among which was the property of the appellants, then it would appear that there was a taking of property by the government without just compensation in violation of the United States Constitution. To the extent that the Comproller was party to such wrongful taking, then liability should exist.

It is reasonably clear that there have been few modern upper court decisions interpreting the power of the Comptroller. The few cases involving the failure of the Bank of

San Diego are lower court decisions. The appellants call upon this Court to interpret the powers of the Comptroller in a modern setting, when those powers have been clearly abused, and to define the limits of the power of the Comptroller concerning the material questions raised by appellants on insolvency and preferences. The theories advanced by appellees have never been sustained by any higher court. The appellees seek to have this Court affirm substantially the lower court's decision so that they may use this Court's affirmance to emasculate other lower court cases that may be pending concerning the broad unrestrained powers that the regulators claim they have.

It appears reasonably clear that we have all experienced (indirectly) and suffered through the tenure of a bad Comptroller. That bad Comptroller abused his authority and power. It is up to this Court to address that problem and to clarify the power and responsibility, not only for the incoming Comptroller in the new administration, but also for the claimants who have suffered under the abuses of the former Comptroller. The issues are far too important not to be firmly, responsibly and courageously decided. The banking system will not fail nor will the Comptroller of the currency be any less the Comptroller if this Court is to establish a basis for accountability and responsibility on the part of the regulators of the banking industry. If the regulators choose, in a moment of crisis, to take a course of action that will damage individuals dealing with banks, then there must ultimately be an outlet for grievances to be heard and the aggrieved to be made whole. Social justice and democracy will be served by providing recourse for persons who may be hurt by the regulators. On the con-

trary, if the arguments advanced by the Comptroller and the FRB and FDIC are accepted and not rejected by this Court, then indeed, a crisis of confidence far greater than any momentary crisis facing the banking system will have presented itself in a subtle and not so obvious way to the American public. Also the court will signal the regulators that they have an open hand that is virtually unassailable to do as they please, always keeping in mind that the rationale of the public interest or the security of the national banking system will serve as an absolute defense to any claim that may be brought. Perchance a claimant succeeds in pushing aside this defense, then all of the regulators will claim some kind of sovereign immunity to avoid any minimal vestige of accountability. I do not believe that the banking community or our society will be served by this Court permitting such a philosophical approach by the regulators to their banking duties to become the law of this land.

III. The Comptroller has failed to cite authority relieving him of liability herein.

Many, if not all, of the cases cited by the Comptroller concern defamation actions. The lower court did not rely at all upon any cases cited to it that concern defamation and slander for the obvious reason that they are, in a sense, apart and separate in judicial philosophy from the usual contractual relationship between the governed and the governing authority. Likewise, cases involving malicious prosecution are questionable as a basis for determining questions concerning preferences among creditors and the duties of the Comptroller to regulate the operation of national banks.

In the 28 years since the case of *Gregoire* v. *Biddle,* 177 F.2d 579 (2d Cir. 1949), our operational form of government has changed dramatically. The government now regulates almost all conduct of its citizens through an army of bureaucrats. No longer can it be said that it is too arduous a burden to submit an official to trial or to public scrutiny for accountability in a court of law. No longer can it be said that officials will flinch in the discharge of their duties if faced with the possibility that they may be called to account. The federal government, with its enormous wealth and power and large staffs of attorneys on every bureaucratic level, is not so weak and helpless that it cannot defend actions brought by the public seeking accountability and responsibility without disruption of governmental operations and decision making. On the contrary, the very dimension of our government today compels us to the conclusion that unlike 30 years ago, it is almost essential that individual plaintiffs be permitted, once they have exhausted appropriate informal and administrative remedies, to take grievance to the court for ultimate resolution. There is no evidence that the Comptroller of the currency would be any less fearless, vigorous or effective in the administration of policies of government were this suit to continue. On the contrary, it is the certainty of the scope of his power and responsibility that will enable the Comptroller to appropriately deal with problems of the magnitude of FNB's insolvency in the future or seek the guiding hand of Congress by appropriate legislation.

The European-American Bank (EAB)

I. The EAB brief has a number of factual statements that are either not found in the record or that are inaccurate.

At the bottom of page 4 of the EAB brief the statement is made that the appellants and one of their subcontractors exerted substantial pressure upon the FDIC and EAB to advance funds under threat of jeopardizing the entire investment. It is remarkable that such a statement would be made in the brief of EAB and that EAB would even admit that the threat of jeopardizing the entire investment would be the basis upon which EAB made a $100,000 advance to the subcontractor in behalf of the appellants.

At the bottom of page 5 EAB suggests that the appellants' construction project, that was virtually brought to a halt, somehow benefited from the delay both financially and by the fair consideration given their project. There is also the assumption in that statement that there was fair consideration given by EAB. When you consider that EAB rejected most, if not all, of the real estate portfolio of FNB, one wonders what is the basis for the statement that appellants received fair consideration by EAB.

At page 2 of the brief, EAB alleges that the appellants have raised a new issue that was not before the lower court. If the issue was not before the lower court, then one must wonder how the lower court could arrive at the conclusion that the indemnity agreement under the Purchase and Assumption Agreement between FDIC and EAB could be an alternative basis for avoiding EAB's responsibility and,

therefore, discharging them from the case. If the lower court believed that the contract between EAB and FDIC was a defense for EAB against the appellants then to that extent the appellants can have their rights determined by reference to that agreement then appellants have the right to rely upon that agreement to seek a basis for the liability of EAB in the breach thereof.

At page 17 of the EAB brief, in paragraph 2, EAB presents argument about substandard loans and seeks by innuendo to suggest that this construction loan was substandard. No facts were alleged that the loan herein was substandard. If it were substandard, then certainly the FDIC and the Comptroller's task force of bank examiners would have acted during the summer of 1974 to eliminate or reduce the loans for this construction project. However, advances were made throughout the spring, summer and into the fall of 1974 which, if anything, suggests the strength of this construction project and FNB's belief that the appellants could deliver a profitable commercial office building. The fact that the FDIC ultimately did not fund this job reflects adversely upon the FDIC and not favorably upon the EAB. The FDIC made few loans or advances to borrowers after the FDIC took over FNB. The FDIC advanced approximately $8 million to borrowers to fund them during the six months to one year period after the take over. When one considers that FNB was once a $5 billion bank, the ratio of $8 million in loans in the year following FNB's insolvency demonstrates the very low percentage of loans actually made by the FDIC.

EAB made the $100,000 advance to the appellants in its own behalf as well as that of the receiver (FDIC). There-

after if EAB properly rejected the loan, then that loan would be transferred back to the FDIC for the account of the receivership estate. Why then does EAB claim that it was an expensive act for EAB at footnote 13 on page 17? It must be assumed that the FDIC rejected the claim of EAB and that the loan was made for and in behalf of the account of EAB and was in effect, a ratification of the appellants' loan with FNB. It would appear that EAB's loan to the appellants herein was part and parcel of the total commercial loan made by FNB to construct Huntington Towers II and was adopted by EAB. The conclusion is inescapable that EAB has ratified and acted upon the agreement between FNB and the appellants herein. The FDIC has confirmed its understanding of this arrangement by its actions herein.

II. EAB cannot avail itself of the Statute of Frauds defense.

The General Obligations Law of New York (Statute of Frauds) does not apply to the loan herein. State law may not impact upon the operation of national banks. FNB had the power to fund the appellants as it did, state law to the contrary notwithstanding. Just because EAB does not claim status as a national bank does not mean that the underlying agreement (which was lawful and to which the N.Y. Statute of Frauds did not apply) was suddenly transmuted into an obligation that could not be enforced because of the status of the successor bank to FNB. If the status of EAB is the basis for avoiding the duty to perform the agreement with the appellants, then certainly these considerations should have been provided for by the Comptroller and the FDIC in any agreement approving the sale of a national bank. Federal banking law should preempt the

N.Y. General Obligation Law. Notwithstanding this argument, the appellants have complied with part performance as required under the N.Y. Statute of Frauds as set forth in the main brief.

What benefit did the appellants receive by creating a $100,000 indebtedness to EAB in the face of the likelihood that there would be no future funding for the construction of Huntington Towers II? It was nothing short of insane for the appellants to obligate themselves to a bank and to pay substantial sums to a subcontractor if the building was not to be fully funded and finished.

The "unequivocally referable" rule has been applied most often to situations where a landlord-tenant relationship exists and, thereafter, the tenant seeks to establish a grantor-grantee relationship to prove a conveyance by the landlord to the tenant. These cited cases are materially different than the facts set forth herein.

III. EAB is liable for anticipatorily refusing to fund the appellants.

The EAB anticipatorily refused funding this project under the Purchase and Assumption Agreement prior to its rejection of the loan as an asset to be assumed by it or the FDIC. Most assuredly, EAB has a duty as a banker to act to protect the assets of the receivership estate if it intended to reject, as it did, most of the real estate portfolio of FNB. Since this construction project was not continuously funded until such time as EAB rejected the loan, the lack of funding by EAB resulted in the shutting down of the job with a great loss of time, money and effort, as well as a weakening of the capacity of the appellants to deliver the completed building in the future and on time.

IV. EAB is not entitled to status as a bona fide purchaser.

The question of bona fide purchaser for value is one that was not fully briefed, at least from the appellants' standpoint, in the lower court. This was due, in part, to the fact that there was really no basis for a determination of EAB being a good faith purchaser. No affidavits on this point were submitted by an officer of EAB. Under the circumstances, the attorney's affidavit should have been rejected. A finding that EAB was a bona fide purchaser would be entirely inappropriate for a number of reasons. The foremost reason being that EAB is clearly not entitled to assume that position where it was intimately involved in a detailed examination of FNB and in the structuring of the kind of deal that it would be willing to bid on in competition with several other banks. Certainly, where a bank plays as active a role as EAB did herein, to structure the deal that it would ultimately bid on, and to go so far as to arrange a loan from the receiver to finance the purchase (and that loan equals or exceeds the purchase price) then there is considerable room for doubt as to whether or not EAB should be entitled to assume the bona fide purchaser position. This is not an arm's length transaction where a receiver offers a property for sale after a declaration of insolvency. All of the negotiations took place before the declaration of insolvency. Simultaneously with the declaration of insolvency, the property was sold in what amounted to an *ex parte* proceeding. The court that approved the sale was briefed in advance in the context of not permitting advance publicity as to the sale and the terms of the transaction. To affirm the lower court in this context is to create a very troublesome precedent that would carry over into non-banking commercial transactions. Plainly, EAB is

too intimately involved to qualify as a bona fide purchaser for value. The Restatement of Trusts is no help to EAB. The cases cited do not support the proposition that in the factual context of the EAB's acquisition of FNB, it is entitled to a good faith purchaser position. For these reasons, it is a non-issue in this case and the court should treat it accordingly.

Conclusion

For the foregoing reasons the final judgment of the District Court entered July 1, 1976, dismissing the complaint against the appellees should be reversed.

Respectfully submitted,

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Service of 2 copies of the within Brief is hereby admitted this 15th day of Dec. 1976

Signed Paula Gazzane

Attorney for U.S. Gov't

Service of 2 copies of the within Brief is hereby admitted this 15th day of Dec. 1976

Signed

Attorney for

Copy received — Hughes Hubbard & Reed 12/15/76

Service of 2 copies of the within Brief is hereby admitted this 15th day of Dec. 1976

Signed Sullivan & Cromwell

Attorney for European American

Service of 2 copies of the within Brief is hereby admitted this 15th day of Dec. 1976

Signed Cahill Gordon & Reindel

Attorney for Federal Reserve Bank of New York